

IN THE
United States
Circuit Court of Appeals
FOR THE NINTH CIRCUIT

WASHMONT CORPORATION, a Corporation,
Appellant,
v.

THOR W. HENRICKSEN, Individually, and as Acting
Collector of Internal Revenue for the Western
District of Washington, Southern Division,
Appellee.

UPON APPEAL FROM THE DISTRICT COURT OF THE UNITED
STATES FOR THE WESTERN DISTRICT OF WASHINGTON,
SOUTHERN DIVISION

HONORABLE JOHN C. BOWEN, *Judge*

BRIEF FOR THE APPELLEE

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INDEX

	Page
OPINION BELOW.....	1
JURISDICTION	1
QUESTIONS PRESENTED	2
STATUTES INVOLVED	3
STATEMENT	4
SUMMARY OF ARGUMENT.....	8
ARGUMENT:	
I. Issuance of nonvoting redeemable stock will not relieve a corporation otherwise taxable as a personal holding company..	10
II. As evidences of debt the debentures were not shares of stock	14
CONCLUSION	31

CITATIONS

CASES:

<i>American Sav. Bank & Tr. Co. v. Lawrence</i> , 114 Wash 198	17
<i>Brown-Rogers-Dixson Co. v. Commissioner</i> , 122 F. (2d) 347	16
<i>Commissioner v. J. N. Bray Co.</i> , 126 F. (2d) 612	18
<i>Commissioner v. O. P. P. Holding Corp.</i> , 76 F. (2d) 11	15, 18, 29
<i>Commissioner v. Palmer, Stacy-Merrill, Inc.</i> , 111 F. (2d) 809	16

CITATION (Continued)

	Page
<i>Commissioner v. Proctor Shop</i> , 82 F. (2d) 792	16, 18, 23, 30
<i>Commissioner v. Schmoll Fils Associated</i> , 110 F. (2d) 611	16
<i>Culbertson's, In re</i> , 54 F. (2d) 753.....	25
<i>Elko Lamoille Power Co. v. Commissioner</i> , 50 F. (2d) 595	16, 25
<i>Farmers State Bank of Lind v. McCulley</i> , 133 Wash 364	17
<i>Helvering v. Richmond, F. & P. R. Co.</i> , 90 F. (2d) 971	23
<i>Hobson v. Marsh</i> , 69 Wash. 326.....	22
<i>Pacific Southwest R. Co. v. Commissioner</i> , 128 F. (2d) 815	15, 16, 18, 22, 29
<i>Parisian, Inc., v. Commissioner</i> , decided Novem- ber 10, 1942	15
<i>Scoville v. Thayer</i> , 105 U. S. 143.....	22
<i>Spencer v. Smith</i> , 201 Fed. 647.....	17
<i>Spiers v. Jahnsen</i> , 143 Wash. 297.....	17
<i>United States v. Gamble-Skogmo</i> , 91 F. (2d) 372	26
<i>United States v. Jefferson Electric Co.</i> , 291 U. S. 386	26
<i>United States v. South Georgia Ry. Co.</i> , 107 F. (2d) 3	16
<i>Walker v. Brown</i> , 165 U. S. 654.....	17
<i>Wells Fargo Bank & Union Trust Co. v. Mc- Laughlin</i> , 78 F. (2d) 934.....	26

CITATION (Continued)

iii

Page

STATUTES:

Remington's Revised Statutes of Washington:

SEC. 10581 21

SEC. 10582 21

Revenue Act of 1936, c. 690, 49 Stat. 1648 as amended:

SEC. 351 3, 8, 14

SEC. 352 3

SEC. 354 3, 11

SEC. 1001 12

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 402 4

SEC. 404 4

Revised Code of Montana (1935), Sec. 6802.... 21

MISCELLANEOUS:

Fletcher Cyclopedia Corporation (Perm. Ed.),

Sec. 5144 22

H. Rep. No. 1546, 75th Cong., 1st Session, pp.

7-8, 10 (1939-1 Cum. Bull. (Part 2) 704,

709, 710) 11, 28

Liens, 33 Am. Jur., Sec. 19, p. 428..... 17

Washington Constitution, Art. 12, Sec. 6..... 22

Webster's New International Dictionary (1933) 15

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BRIEF FOR THE APPELLEE

OPINION BELOW

The only previous opinion in this case is that of the District Court (R. 19-26) as yet unreported.

JURISDICTION

This notice of appeal (R. 34-37) involves federal income tax for the calendar years 1937 and 1938, paid

by the taxpayer on or about July 8, 1940. (R. 29-30) On July 19, 1940, the taxpayer filed a claim for refund with the appellee as acting Collector of Internal Revenue. (R. 30.) This claim was rejected by the Commissioner of Internal Revenue on December 13, 1940. (R. 30.) More than six months thereafter and on February 19, 1941, the taxpayer instituted an action in the District Court for the Western District of Washington for recovery of taxes paid under the provisions of Section 24, Fifth, of the Judicial Code as amended. (R. 2-6.) The judgment of the court denying the claim was entered March 4, 1942. (R. 33-34.) Within three months and on May 25, 1942, the taxpayer filed a notice of appeal in this Court (R. 34-35) pursuant to the provisions of Section 128(a) of the Judicial Code as amended.

QUESTIONS PRESENTED

1. If "Participating Dividend Debenture Certificates", issued by the taxpayer, were stock does the taxpayer's right to redeem them constitute an "option to acquire stock" within the meaning of Section 354 of the Revenue Act of 1936 and Section 404 of the Revenue Act of 1938 so as to render the taxpayer taxable as a personal holding company?

2. Were “Participating Dividend Debenture Certificates”, issued by the taxpayer, stock within the meaning of Section 351 of the Revenue Act of 1936 and Section 402 of the Revenue Act of 1938 so as to exclude the taxpayer from taxation as a personal holding company whose stock was held by not more than five individuals?

STATUTES INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648, as amended by the Revenue Act of 1937, c. 815, 50 Stat. 813, Sec. 1:

SEC. 352. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General Rule.*—For the purpose of this title and of Title I the term “personal holding company” means any corporation if—

* * *

(2) *Stock Ownership Requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

* * *

SEC. 354. STOCK OWNERSHIP.

(a) *Constructive Ownership.*—For the purpose of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership under section 352 (a) (2), section 353 (e), or section 353 (f)—

(1) *Stock Not Owned by Individual.*—Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners or beneficiaries.

* * *

(3) *Options.*—If any person has an option to acquire stock such stock shall be considered as owned by such person. For the purposes of this paragraph an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

* * *

(5) *Constructive Ownership as Actual Ownership.*—Stock constructively owned by a person by reason of the application of paragraph (1) or (3) shall, for the purpose of applying paragraph (1) or (2), be treated as actually owned by such person; but stock constructively owned by an individual by reason of the application of paragraph (2) shall not be treated as owned by him for the purpose of again applying such paragraph in order to make another the constructive owner of such stock.

* * *

Sections 402(a) (2) and 404(a) (1) (3) and (5), respectively, of the Revenue Act of 1938, c. 289, 52 Stat. 447, are identical with the above.

STATEMENT

From the findings of the District Court and the undisputed testimony adduced by the taxpayer the relevant facts may be briefly summarized as follows:

Associated Breweries of Canada, Ltd. (referred to herein as Associated) was a Canadian corporation and at no time during 1937 or 1938 was 50 percentum of value of its outstanding stock owned by five or less individuals. (R. 30-31.) Prior to April, 1937, Associated owned the controlling stock interest in several American breweries. (R. 56, 60.) A Mr. Emil G. Sick, a citizen of the United States and president of Associated, also owned stock in these American breweries. (R. 55, 57.) Because ownership of this stock by Associated, a Canadian corporation, prevented local control of these breweries it was thought the ownership was violative of Montana and Washington statutory prohibitions against alien ownership of land and it was decided to divest Associated of this substantial stock ownership. (R. 43, 55, 56, 60.) Accordingly, Mr. Sick organized the Washmont Corporation, the taxpayer, as a holding company in April, 1937. (R. 43-44.) The taxpayer's articles of incorporation authorized 50,000 shares of \$1 par value voting stock. (R. 49.)

On organization of the taxpayer Mr. Sick transferred to it stock owned by him in a Seattle Brewing and Malting Company valued at \$25,000 and received from the taxpayer 24,800 of its par \$1 voting shares. One hundred shares each were issued to two other individuals. (R. 50-51.) Pursuant to the plan to

use the taxpayer holding company as a device to divest Associated of any control of Washington and Montana breweries the taxpayer corporation received from Associated controlling stocks in these American breweries valued at \$625,000. (R. 52, 53, 56, 58.) In exchange Associated received the taxpayer's "Participating Dividend Debentures" in the amount of \$625,000. (R. 42, 52-53, 66.)

Under these debentures the taxpayer acknowledged indebtedness for and promised to pay the principal sum 20 years from date. The debenture was stated to be a lien on the property and net earnings of the company. Interest on the debenture was payable semiannually at the rate of three per cent per annum solely from net earnings. After the common stock had received a three per cent dividend, available earnings were to be divided between the debentures and the common stock proportionately on the basis of their aggregate par value. On redemption the debentures were entitled to share in any surplus. They were transferable only through the registry books of the corporation. (R. 64-66.) No vote was given the holder. (R. 20.)

In connection with this \$625,000 debenture issue the taxpayer did not attempt to secure any increase in

the \$50,000 capital stock authorized by its articles of incorporation. (R. 49, 53.) For the tax years 1937 and 1938 the taxpayer claimed interest deductions for interest payments made to the debenture holders in the sum of \$12,698.04 and \$19,165.21, respectively. (R. 22-23, 61-62.) In dealing with its bank the taxpayer's debentures were represented by it as a stock interest. (R. 22, 39.)

For the years 1937 and 1938 the taxpayer filed income tax returns as an ordinary corporation. (R. 28-29.) Thereafter the Commissioner assessed deficiencies and penalties against it on the ground that it was a personal holding company within the meaning of and subject to the tax imposed by Section 351 of the Revenue Act of 1936 as amended, and Section 401 of the Revenue Act of 1938. (R. 29.) (Since the relevant provisions are identical reference herein will be made only to the Revenue Act of 1936.) The deficiencies and penalties assessed for 1937 were \$3,445.26 and for 1938 were \$2,680.04. Subsequently the taxpayer paid these assessments with interest. (R. 29.) A minor adjustment was allowed by the Commissioner. (R. 30.) This suit was instituted to recover the balance, some \$6,693.98. (R. 6.)

The above facts were developed by the witnesses for the taxpayer in the District Court. In addition

the taxpayer sought to introduce evidence that, after it learned the Bureau of Internal Revenue regarded the debentures as something other than stock, with resultant classification of the taxpayer as a personal holding company, the taxpayer took steps to convert the debentures into preferred stock. This evidence was ruled inadmissible by the District Court. (R. 45.)

The District Court found that the "debentures" were evidence of debt and were so intended on their issue. (R. 31.) Accordingly, since the common stock of the taxpayer was held by not more than five individuals, to-wit, three, and since its income was personal holding company income it was held subject to the tax levied thereon by Section 351 of the Revenue Act of 1936. (R. 29, 31-32.) From the judgment of District Court against it (R. 33-34) the taxpayer has prosecuted this appeal.

SUMMARY OF ARGUMENT

Even if the debentures should be regarded as stock the taxpayer is taxable as a personal holding company. The debentures are redeemable at the taxpayer's option. Under Section 354 of the Revenue Act of 1936 one who holds an option to acquire stock is to be deemed the owner thereof in determining

whether the corporation is a personal holding company. The right of the taxpayer corporation to redeem the debentures constitutes such an option to acquire stock. The debentures therefore, even if considered as stock, will not enlarge the number of the taxpayer's stockholders to more than five. The taxpayer is therefore taxable as a personal holding company if the debentures represent stock.

Actually the debentures do not represent stock. The debenture instrument identifies itself as a debenture rather than a stock with an acknowledgment of indebtedness and a promise to pay the principal sum 20 years from date.

The several circumstances surrounding the issue and its treatment also establish that the debentures were not intended as stock. From a consideration of all the testimony respecting these circumstances the District Court found that the taxpayer's incorporators intended the debenture certificates to represent indebtedness and not stockholding interest. There is ample support for that finding in the record. Hence the fact that the parties intended the debentures to be what they purport to be, i. e., bonds, must be accepted on appeal.

Since the debentures purport to be bonds rather

than stock and since they were so intended it follows they cannot be regarded as stock increasing the number of the taxpayer's shareholders to more than five. The taxpayer was therefore properly held taxable as a personal holding company under Section 351 of the Revenue Act of 1936.

ARGUMENT

I

ISSUANCE OF NONVOTING REDEEMABLE STOCK WILL NOT RELIEVE A CORPORATION OTHERWISE TAXABLE AS A PERSONAL HOLDING COMPANY

Even if the debentures issued by the taxpayer corporation be regarded as stock the taxpayer is taxable as a personal holding company. Its income is concededly personal holding company income. (Br. 2.) The only question therefor is whether the taxpayer's stock was owned by more than five persons within the meaning of Section 352(a) (2) of the Revenue Act of 1936. Since Section 354(a) (1) of this act provides that stock owned by a corporation is to be considered as owned by its shareholders and Associated has several hundred shareholders (R. 55) it would follow that the taxpayer's stock would be owned by more than five persons *if the debentures were ordi-*

nary stock. As will be seen in the following section the debentures were not stock at all. Assuming arguing that they were stock, however, consideration must be given the effect of their provision that "the debentures of this issue are * * * subject to redemption * * * on any interest payment date [May 1 and November 1 of each year] * * * after the company shall have given one month's notice of the intention to pay and redeem the same, * * *." (R. 66.)

Under Section 354(a) (3) of the Revenue Act of 1936 it is provided that "if any person has an option to acquire stock such stock shall be considered as owned by such person [for the purpose of determining whether a corporation is a personal holding company]." The purpose of this provision, of course was to prevent evasion of the personal holding company tax by issue of stock to others which the five or less guiding spirits of the holding company could acquire during the taxable year by exercise of purchase options retained by them.¹ It is apparent that issuance of redeemable nonvoting stock to others

¹ H. Rep. No. 1546, 75th Cong., 1st Sess., pp. 7-8 (1939-1 Cum. Bull. (Part 2) 704, 709):

Paragraph (3) of subsection (a) provides that if any person has an option to acquire stock such stock may be considered as owned by such person. * * * Under existing law, some individuals try to circumvent the provisions of section 351 by splitting up the

by a corporation having five or less voting shareholders is in substance the same device. To proscribe the first scheme and permit the second would be an invitation to evasion of the tax imposed on personal holding companies not lightly to be attributed to Congress. In outlawing the "option to acquire stock" as a personal holding company tax evasion device Congress, on the contrary, clearly struck at all such schemes.

The term "person", as used in the Revenue Act of 1936 to which the Revenue Act of 1937 is merely an amendment, includes "an individual * * * or a corporation". (Section 1001 of the Revenue Act of 1936.) (*Italics supplied.*) The taxpayer is thus within the provision of Section 354(a) (3) of the Revenue Act of 1936 that "if any person has an option to

ownership of stock among more than five individuals but giving less than five individuals an option to acquire the stock at any time they desire. For example, five individuals may own 49 per cent of the value of the outstanding stock of a corporation and one of them may have an option to acquire 2 per cent or more in value of the shares. In such a case, they are for all practical purposes in the same situation as if they owned 51 per cent in value of the stock. If the stock which such individual had a right to acquire by option was added to the other shares actually owned by him, there would be a sufficient stock ownership to bring the company within the personal holding company stock ownership test. The amendment proposed by your committee adopts such a rule.

acquire stock such stock shall be considered as owned by such person". That a right in a corporation to acquire its stock is an option to acquire stock is evident. The requirements in the debenture that such acquisition take place on one of two interest payment dates each year and that notice must be given before such acquisition does not change the character of the option. If the debentures were stock then for purposes of determining whether the taxpayer is a personal holding company the taxpayer corporation is to be regarded as the owner of this "stock".

This "ownership" of this "stock" by the taxpayer under Section 354(a) (3) thus prevents it from escaping classification as a personal holding company. Section 354(a) (5) of the act provides that "stock constructively owned by a person by reason of the application of paragraph * * * (3) shall, for the purpose of applying paragraph (1) * * *, be treated as actually owned by such person; * * * ". The corporation is therefore to be treated as the actual owner of the "stock" for purposes of applying Section 354(a) (1). Under Section 354(a) (1) "stock owned, * * * by * * * a corporation, * * * shall be considered as being owned proportionately by its shareholders, * * * ." The debentures in question must therefore be deemed under the statute to be the prop-

erty of the taxpayers' three common stockholders.² Thus the taxpayer's stock is, within the meaning of the Act, owned by five or less individuals, to-wit, three, and hence it is taxable as a personal holding company.

The only point of vulnerability in this analysis is the assumption the debentures constitute stock. If they do not constitute stock, however, it is equally clear the taxpayer has five or less shareholders and is taxable as personal holding company.

II

AS EVIDENCES OF DEBT THE DEBENTURES WERE NOT SHARES OF STOCK

The taxpayer concedes (Br. 2-3) that unless the debentures issued by the taxpayer and held by Associated are shares of stock then the taxpayer's stock is held by not more than five persons and it is taxable as a personal holding company under Section 351 of the Revenue Act of 1936. These debentures clearly did not represent stock.

² The purpose of Section 354(a) (3) is to eliminate as shareholders those holding stock subject to an option. See fn. 1, *supra*. Neither Associated nor its stockholders can be counted as the taxpayer's shareholders of this redeemable stock for this reason.

The security was classified as a "Participating Dividend Debenture" by the taxpayer in the first instance. The term "debenture" has a clear and well known meaning, i. e., an instrument of indebtedness, a bond. Webster's New International Dictionary (1933). That this designation of the instrument by the taxpayer as a debt is to be given great weight is settled. *Parisian, Inc. v. Commissioner* (C.C.A. 5th), decided November 10, 1942 (1942 Prentice Hall, par. 63028); *Commissioner v. O.P.P. Holding Corp.*, 76 F. (2d) 11 (C.C.A. 2d). See also concurring opinion of Judge Healy in *Pacific Southwest R. Co. v. Commissioner*, 128 F. (2d) 815 (C.C.A. 9th). While participation in dividends may be an attribute not common to corporate bond issues, this attribute is simply an addition to and does not purport to destroy the fundamental nature of the debenture as a corporate debt. This is made clear by provisions of the debenture itself. Therein the taxpayer corporation "acknowledges itself indebted and promises to pay to the registered owner hereof, on or before twenty years from the date hereof, or on a date to be fixed as hereinafter provided and for the retirement of this debenture, the sum of * * *." It is further provided that "this debenture constitutes a lien upon the property and net earnings of the company and the company hereby charges with the payment of its under-

taking herein all of its property whatsoever and wheresoever, both present and future". (R. 64-65.)

These provisions establish that the security was properly classified by the taxpayer in the first instance as a debenture rather than a stock. The promise to repay the principal sum at a definite maturity date constitutes well nigh, if not, conclusive evidence that the debenture is an evidence of indebtedness rather than a stock. This Court has so held on numerous occasions. *Commissioner v. Palmer, Stacy-Merrill, Inc.*, 111 F. (2d) 809, 810; *Commissioner v. Proctor Shop*, 82 F. (2d) 792, 795; *Elko Lamoille Power Co. v. Commissioner*, 50 F. (2d) 595, 597. Accord: *United States v. South Georgia Ry Co.*, 107 F. (2d) 3 (C.C.A. 5th); *Commissioner v. Schmoll Fils Associated*, 110 F. (2d) 611 (C.C.A. 2d); *Brown-Rogers-Dixson Co. v. Commissioner*, 122 F. (2d) 347 (C.C.A. 4th). Although this Court held a maturity date ineffective to constitute a security a debt in *Pacific Southwest R. Co. v. Commissioner*, 128 F. (2d) 815, it was because the security was styled preferred stock and intended as such—persuasive identification marks absent here.

(In addition to a promise to repay the principal sum at a definite maturity date it will be noted that the debenture is stated by its terms to be a lien on the

corporate property. Entirely apart from the validity of such a lien this provision, designed to give Associated priority over subsequent creditors, is additional evidence the debenture was intended as evidence of indebtedness. Actually it is clear under Washington law that as against creditors with notice this lien would have been valid as an equitable lien so as to give Associated a claim paramount to such creditors. *American Sav. Bank & Tr. Co. v. Lawrence*, 114 Wash. 198, 194 Pac. 971; *Farmers State Bank of Lind v. McCully*, 133 Wash. 364, 233 Pac. 661; *Spiers v. Jahnsen*, 143 Wash. 297, 255 Pac. 117. Accord: *Walker v. Brown*, 165 U. S. 654. For extensive citations supporting this general principle see Liens, 33 Am. Jur., § 19, p. 428. That such a lien might not be valid if the debenture had been classified on the taxpayer's balance sheet and registered with the State of Washington as preferred stock (Cf. *Spencer v. Smith*, 201 Fed. 647 (C.C.A. 8th), cited by the taxpayer (Br. 7)) is not at all persuasive of its invalidity when incident to a debenture called such. This lien clearly establishes the debenture holder as a creditor.

Against these provisions above referred to the taxpayer points to the fact that interest on the debentures was payable only out of earnings. Our con-

cern is, of course, with the ultimate character of the debenture, not the nature of the payments thereon—a consideration that suggests caution in complete reliance on decisions concerned with the nature of payments as interest or dividends. Admittedly, by and of itself, provision for distributions solely out of earnings suggest a stock interest. As an isolated attribute it does not compel that conclusion, however, when in company with others that reveal the security as an evidence of indebtedness—its title as a bond and a promise therein to pay the principal sum at a certain maturity date. Cf. *Commissioner v. Proctor Shop*, 82 F. (2d) 792 (C.C.A. 9th) (interest there was subordinated to creditor claims but debenture preference stock was held a debt); *Commissioner v. O.P.P. Holding Corp.*, 76 F. (2d) 11 (C.C.A. 2d) (interest could be postponed by the corporation but the bond was held an indebtedness); *Commissioner v. J. N. Bray Co.*, 126 F. (2d) 612 (C.C.A. 5th) (interest was “cumulative” but the security was held to be a bond).

The best illustration of this proposition that dependence of interest on earnings will not alone convert an instrument of indebtedness into stock is the income bond, a security most certainly not regarded as a stock interest. In *Pacific Southwest R. Co. v. Commissioner*, 120 F. (2d) 815, this Court held pay-

ments from earnings to be dividends when made on a certificate styled "preferred stock" and intended as a stock issue.³ As Judge Healy's concurring opinion observed (p. 819):

If they had been denominated "bonds" rather than preferred stocks, I apprehend that nobody would contend that they were not true evidences of debt or that the returns paid thereon were anything other than interest.

The taxpayer argues as well that provisions in the debenture entitling it to a proportionate share of surplus on retirement stamps the debenture as a stock. It is significant that Associated did not assume any risk of loss so this right might well be regarded as a premium for making the loan. The taxpayer urges, however, that the parties could not have intended this species of "after-acquired-property clause" to operate to the prejudice of other creditors and that the debenture as a whole should therefore be treated as no

³ It is noteworthy that Article 23 (b)-1 of Regulation 94, issued under the Revenue Act of 1936, and the identical Regulations under the Revenue Act of 1938, classify as dividends "so-called interest on preferred stock". No such provision is made with respect to interest on debentures.

It may be suggested as well that interest is ordinarily paid from earnings. It cannot long be paid otherwise in the usual situation. That payments are made from earnings in fact does not, however, convert interest into a dividend.

debt but as an equity interest. That this provision might prejudice other creditors to the extent enforceable as a secured or unsecured debt may be conceded. The debentures clearly provide however for that result. The assertion that they could not have been so intended simply begs the question.

From the various provisions in the certificates, their classification as debentures, the acknowledgment therein of indebtedness, the promise to pay the principal sum at a certain maturity date and statement that the debenture constituted a lien on the corporate property, it is clear that on their fact these debentures are evidences of indebtedness rather than shares of stock. The only question remaining is whether any extraneous circumstances indicate they were intended as anything else.

Consideration may first be given the circumstances surrounding issuance of the debentures. The taxpayer was organized in order to provide "local control" for certain operating breweries in which Associated, a Canadian corporation, owned substantial amounts of stock. (R. 56.) Mr. Sick, president of the taxpayer and of Associated as well, testified that this desire for "local control" was prompted by a well grounded fear that Washington and Montana statutes prohibiting alien ownership of land required local con-

trol. (R. 60.) By their terms these statutes forbid aliens to control or own a majority of the capital stock of a corporation owning land. ^{3A} Associated's control over stock in Montana and Washington breweries might have been divested by issue to it of nonvoting preferred stock of the taxpayer holding company in exchange for these brewery stocks. That possibility

^{3A} The Washington statutory prohibition against alien ownership of land is found in Remington's Revised Statutes of Washington, Secs. 10581 and 10582:

SEC. 10581. *Aliens—Rights and disabilities—Definitions.* In this act, unless the context otherwise requires:

—(a) “Alien” * * * does include * * * all corporation * * * a majority of whose capital stock is owned or controlled by aliens * * *;
* * *

(c) “Land” also includes any share or interest in a corporation or other organized group of persons deemed an alien in this act which has title to land either heretofore or hereafter acquired;

(d) To “own” means to have the legal or equitable title to or the right to any benefit of;
* * *

SEC. 10582. *Aliens—Restrictions as to land.* An alien shall not own land or take or hold title thereto. * * *

The Montana statute is similar. Revised Code of Montana (1935), Sec. 6802.

It is noteworthy that these statutes are directed at alien majority control *or* ownership of a corporation's capital stock. This perhaps explains why debentures rather than preferred stock were issued.

was considered by Mr. Sick and his colleagues, including an attorney, but preferred stock was rejected for the reason that "in compliance with the law something other than preferred stock might be required." (R. 60.) In other words it was thought that Associated must be divested of ownership of this stock in the American breweries. Accordingly the taxpayer's debentures were issued as evidences of debt rather than as stock. This circumstance is persuasive the parties intended the debentures to be evidence of debt rather than stock. Cf. *Pacific Southwest R. Co. v. Commissioner*, 128 F. (2d) 815 (C.C.A. 9th), where an intention to escape taxation by issuing stock was held persuasive that a stock issue was intended.

A further circumstance indicating the parties' intention is the fact that at the time the \$625,000 debentures were issued the taxpayer's authorized capital stock was only \$50,000. (R. 73.) If the debentures were stock they would have been void as unauthorized stock. Washington Constitution, Art. 12, Sec. 6; *Scoville v. Thayer*, 105 U. S. 143; *Hobson v. Marsh*, 69 Wash. 326, 124 Pac. 912; Fletcher Cyclopedia Corporation (Perm. Ed.), Sec. 5144.

The parties certainly did not intend the issue of a security in a form that would have made it invalid. That they fully appreciated the necessity of increasing

their authorized capital stock had the debentures been stock is established by the consulting attorneys' testimony that the debentures were not drawn as stock "in the sense of represented stock on file with the Secretary of State.". (R. 44.)

Still another circumstance persuasive that the parties regarded the debenture as a bond rather than a stock is the fact that for the tax year here involved the interest paid on the debentures was claimed and allowed as a deduction on the taxpayer's income tax returns as interest on indebtedness. (R. 22-23, 61-62.) This circumstance is entitled to weight on the question of the classification of the debenture. *Helvering v. Richmond, F. & P. R. Co.*, 90 F. (2d) 971 (C.C.A. 4th).

Against the foregoing circumstances reenforcing the view that the parties intended the debenture to be evidence of a debt rather than stock the taxpayer points first to testimony by its witnesses that the debentures were not regarded by it or by Associated as giving the latter a claim paramount to general creditors. It is not at all clear that subordination of a bondholder's claim to general creditors would rob him of a creditor's status. In *Commissioner v. Proctor Shop*, 82 F. (2d) 792, this Court held the contrary.

Apart from that, however, little weight can be attached to this testimony in light of the fact that no adverse interest of Associated with relation to general creditor claims is presented by this proceeding. In view of the explicit provisions in the debentures making them debts and secured debts at that, there is basis for considerable doubt, moreover, whether general creditors with notice of the debenture provisions could assert priority over the holder thereof. See Washington cases cited, *supra*.

The testimony that the taxpayer represented to its banker that the debentures were stock is likewise unconvincing, as the District Court observed. (R. 22-24.) This evidence simply establishes a self-serving vacillation on the part of the taxpayer. When income taxes were to be computed debenture interest was treated as deductible interest on indebtedness. When money was to be borrowed the debentures were regarded as venture-sharing stock investments.

Finally the taxpayer refers to evidence ruled inadmissible by the District Court to the effect that, after being apprised of its probable liability to taxation as a personal holding company because the debentures were not stock, the taxpayer's directors saw the error of the course they had pursued and determined

to replace the debentures with preferred stock. (R. 45.) As a self-serving act after the issuance of the debentures this evidence was not relevant. This Court has previously pointed out that it is the intention at the time of issue that is important in determining the nature of the security—not some subsequent intention. *Elko Lamoille Power Co. v. Commissioner*, 50 F. (2d) 595, 597; *In re Culbertson's*, 54 F. (2d) 753, 758. As a matter of fact this evidence seems actually to represent a confession that the debentures as issued did not constitute stock, any declaration to the contrary notwithstanding. (R. 72-74.) It is noteworthy that the preferred stock issued to replace the debentures was covered by an increase in the authorized capital stock of the taxpayer and that it contained no maturity date or promise to pay the principal amount as a debt. (R. 73-74.) It might be that this offered testimony should have been admitted as a declaration against interest. The taxpayer was certainly not prejudiced by its exclusion.

Consideration of all of the foregoing testimony requires the conclusion that the preponderance of the evidence establishes the parties intended the debentures to be something other than stock at the time of their issue, i.e., evidences of indebtedness. The question of the parties' intention is of course a matter of

fact as the taxpayer concedes. (Br. 18.) The District Court found on the basis of the testimony adduced before it that "plaintiff's incorporators at the time of the issuance of the debenture certificates intended them to represent indebtedness of the plaintiff and not legal stockholder interest in plaintiff; that by the written terms of the certificates themselves, they created and were intended to create an indebtedness against the plaintiff corporation rather than a stockholder's interest therein". That there is evidence in the record to support this finding is clear from the foregoing review. The fact that the extraneous circumstances show that the debentures were not intended as stock must therefore be accepted as conclusive by the appellate court. *United States v. Jefferson Electric Co.*, 291 U. S. 386, 407; *Wells Fargo Bank & Union Trust Co. v. McLaughlin*, 78 F. (2d) 934, 936 (C.C.A. 9th); *United States v. Gamble-Skogmo*, 91 F. (2d) 372 (C.C.A. 8th). The taxpayer's suggestion (Br. 11) that the findings of the District Court are not to be accorded the respect given those of the Board of Tax Appeals has no support in the decided cases and is not entirely convincing in and of itself. It is noteworthy that this Court, in attaching weight to the intention of the parties in determining the nature of a security as a bond or stock for tax purposes has in all

cases accepted the lower tribunal's findings on the factual question of intent. *Elko Lamoille Power Co. v. Commissioner*, *supra*; *Commissioner v. Proctor Shop*, *supra*; *Commissioner v. Palmer, Stacy-Merrill, Inc.*, *supra*; *Pacific Southwest R. Co.*, *supra*.

Since the debentures on their face are not stock but evidences of indebtedness and since the parties intended then so to be, it is clear they cannot be regarded as stock for the purpose of relieving the taxpayer from classification as a personal holding company. This conclusion is reeinforced by consideration of the nature of the burden of proof resting on the taxpayer.

The Commissioner determined that the taxpayer was taxable as a personal holding company and his determination is presumptively correct. In order to disturb that determination it was for the taxpayer to clearly demonstrate that the debentures were stock. To show that the debentures had some characteristics of stock would not satisfy this burden of proof or the requirement of the statute. The taxpayer was bound to prove that the debentures actually were stock. In this connection it is significant that Section 354(b) of the Revenue Act of 1936 provides that securities convertible into stock cannot be considered as stock if

the effect is to remove the corporation from classification as a personal holding company. The committee report on this provision explains that "debentures" with conversion privileges fall in this group.⁴ Hence it is abundantly clear that Congress did not intend "debentures" without conversion privileges to be regarded as stock.

At best the taxpayer adduced some evidence tending to indicate the debentures were bonds with some stock characteristics. In order to escape classification as a personal holding company, however, the taxpayer was bound to clearly establish the debentures were stock. Hence the decision of the District Court that the taxpayer had failed in its proof was correct.

The decisions relied on by the taxpayer are all distinguishable from the instant case.

⁴ H. Rep. No. 1546, 75th Cong., 1st Sess., p. 10 (1939-1 Cum. Bull. (Part 2) 704, 710), states:

The reason for this rule [that convertible securities may be counted to make the corporation a personal holding company but not otherwise] is that it appears that the real owners of certain of these incorporated pocketbooks may own bonds, debentures, or other corporate obligations which contain provisions under which they may be converted into stock. Without such a rule, it might be possible for the company to escape classification as a personal holding company by having its stock held by more than five individuals and at the same time having the interest of the real owner represented by convertible securities.

Representative of these cases is this Court's recent decision in *Pacific Southwest R. Co. v. Commissioner*, 128 F. (2d) 815. The security there involved was properly classified as stock for it was styled "preferred stock" by the issuing corporation and extraneous circumstances showed the parties intended that it should be stock. All of the other decisions cited by the taxpayer where securities were classified as stock involved one or both of these factors. It is the absence of those factors that requires classification of the taxpayer's debentures as evidences of indebtedness in this case.

A case similar to the present one in many respects is that of *Commissioner v. O.P.P. Holding Co.*, 76 F. (2d) 11 (C.C.A. 2d). There the taxpayer, a holding company, acquired all of an operating company's stock and issued in exchange therefor 1,000 shares of \$100 common stock and \$250,000 of its "debenture bonds". The taxpayer's authorized capital stock was only \$20,000. The debentures had a definite maturity date and drew interest at eight per cent but interest payments could be postponed by the corporation. The debentures were subordinated to the claims of general creditors. The court held these debentures to be evidences of indebtedness and the payments thereon to be interest. The taxpayer's classi-

fication of the security as a bond and the presence of a maturity date were the factors that prompted this decision. Cf. *Commissioner v. Proctor Shop*. 82 F. (2d) 792. (The facts are very similar and this Court held "debenture preference stock" evidenced indebtedness.) So also must it be concluded here that the taxpayer's debentures were evidences of indebtedness rather than of stock.

In the event this Court should hold that the taxpayer is not taxable as a personal holding company it would follow that the taxpayer was not entitled to the deductions for interest on the debentures in the amount of \$50,000 and \$31,250 allowed for the tax years 1937 and 1938, respectively. As pleaded in the defendant's answer, therefore, the plaintiff's recovery in that event should be reduced by the amount of income and excess profits taxes to this deduction. (R. 17-18.)

CONCLUSION

The decision of the District Court was correct and should therefore be affirmed.

Respectfully submitted,

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